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SUBJECT: Ringgit Rises as Proton Flounders: Malaysia Economic Update for May 2007

1. Summary:

- Malaysia's currency continued its gradual rise against the U.S. dollar to reach a near 10 year high.
- The Malaysian cabinet, reacting to loud protests from non-Malays, ordered the country's largest commercial bank to withdraw a requirement that law firms conducting business with the bank have at least one Malay partner with at least a 50% equity interest.
- Malaysia has proposed building a trans-peninsula crude oil pipeline to ease congestion in the Straits of Malacca and to provide an alternative route for getting Middle East oil to buyers in East Asia.
- At the 4th Malaysian International Halal Showcase Prime Minister called on Malaysian producers of halal food to improve their practices in order to boost the country's goal of becoming a "halal hub".
- A GOM official said the government will not bail out Proton, Malaysia's national carmaker, which continues to bleed cash as it searches for a foreign strategic partner.

End Summary.

The Ringgit Strengthens to 10-year High

12. The Malaysian ringgit rose to a near 10-year high of 3.388 to the U.S. dollar on May 21, appreciating 0.13% soon after China raised interest rates and widened the yuan trading band to a range of 0.5% from 0.3% previously. The currency also broke the psychological barrier of 3.4 to the dollar. Since early January, the ringgit has gained 4.1% against the U.S. dollar but has depreciated 2% against the yuan and most of other regional currencies. The Malaysian currency had been pegged at a rate of 3.8 to the dollar from September 1998 (in the wake of the Asian financial crisis) to July 2005, when the GOM announced that it would allow the currency to appreciate by switching to a managed float system.

13. Bank Negara Governor Zeti Akhtar Aziz rushed to clarify that the ringgit was moving in line with the Malaysian economy and not in tandem with the yuan. However, many traders and speculators thought otherwise, saying that as long as the yuan strengthened they would rush to buy ringgit in anticipation of the ringgit's appreciation. Governor Zeti said on May 29 that the central bank is not targeting the ringgit to appreciate to any specific level but to move in an orderly manner in line with market conditions.

14. Analysts generally expect the ringgit to continue strengthening, possibly to between 3.35 and 3.3 against the U.S. dollar by year-end, and at a pace tempered by Bank Negara's cautious intervention. Many local analysts also believe that the ringgit remains competitive with other regional currencies, though Rating

Agency Malaysia's (RAM) chief economist Yeah Kim Leng said the government's current strong ringgit policy encourages speculators to enter the currency market. For the first two weeks in May alone, Malaysia's foreign reserves rose by nearly USD 3 billion to USD 94.5 billion, equivalent to 8.6 months of retained imports and 9.6 times the short-term external debt.

Largest Local Bank Withdraws Race-Based Lawyer Rule

¶15. The Malaysian Cabinet has ordered Maybank, the country's largest commercial bank, to withdraw a requirement that law firms conducting business with the bank have at least one bumiputera partner and that bumiputera partners collectively hold at least a 50% equity stake in the firm ("bumiputera", literally "sons of the soil", is a term the GOM uses to describe majority ethnic Malays and Malaysia's minority indigenous tribe people, mainly as means of distinguishing this group from Chinese-Malaysians and Indian-Malaysians). Following the Cabinet's order, Maybank issued a statement saying that with immediate effect all solicitor firms, whether with bumiputera or non-bumiputera equity ownership, are eligible for consideration to do business with the bank.

¶16. Maybank had earlier sent letters to lawyers demanding compliance with the bumiputera equity requirement if they wanted to be or remain on its legal panel, generating much controversy and criticism from the non-bumiputera community as being discriminatory. After loud protests from the Malaysian Chinese Association (a component party of the ruling Barisan Nasional, or National Front, party) as well as the Associated Chinese Chamber of Commerce and Industry and the Malaysian Bar Council, the Cabinet decided at its weekly meeting on May 9 to order Maybank to withdraw the policy. The opposition party Democratic Action Party (DAP) took the opportunity to call for the public's support for a boycott of the bank. Senior government officials from the Central Bank and the Ministry of Finance denied the government had anything to do with the race-based requirement issued by Maybank, a government linked corporation (GLC) that is 2/3rds owned by other GLCs.

Malaysia's Ambitious Oil Pipeline Project

¶17. Malaysia has proposed building a 320 km trans-peninsula crude oil pipeline from Yan, in Kedah state in northwestern peninsular Malaysia, to Bachok, a town in Kelantan state in northeastern peninsular Malaysia. The project is expected to kick-off with a USD 2.3 billion pipeline with a capacity to transfer two million barrels of oil per day. The project eventually would include three pipelines with a total cost of USD 7 billion. Syed Izhar Al-Idrus, the director of the project's promoter, Trans Peninsula Petroleum Sdn Bhd (TPP), said the pipeline will provide an alternative route for transporting crude oil from Middle East suppliers to buyers in East Asia. It is also expected to help ease congestion in the busy Straits of Malacca. Kuala Lumpur-based construction giant Ranhill Berhad announced on May 28 that its subsidiary, Ranhill Engineers and Constructors Sdn Bhd, has entered into an agreement with TPP and Jakarta-based P.T. Tripatra Engineers and Consultants for the design, engineering, procurement, construction and testing of the project, which is expected to begin in 2008 and be completed in 2014.

PM Exhorts Halal Industry to Achieve Best Practices

¶18. Prime Minister Abdullah has called on Malaysian producers and manufacturers of halal food (i.e., food prepared in accordance with or permitted under Islamic law) to meet the GOM's best practice requirements in safety, health and quality in order for Malaysian halal brands to achieve premium status. Abdullah, who attended the May 10 opening of the 4th Malaysian International Halal Showcase (MIHAS 2007), said achieving these requirements will boost acceptance and marketability of halal food to non-Muslim markets. Malaysia's commitment to become a "Halal Hub", which was set forth in the Ninth Malaysia plan and the Third Industrial Master Plan, includes engaging local universities to develop and offer academic programs in halal related areas.

¶19. The organizer of MIHAS 2007 said exhibitors at this year's convention recorded RM 213.9 million (US 63 million) in immediate

sales as a result of their participation compared with RM 168 million (US 49.4 million) in sales at last year's convention, prompting many exhibitors to place bookings for next year's event. The official said MIHAS is planning to pull together resources from the government and private sector to cover a wider span of economic activities related to halal products, from farming, manufacturing, and processing to the importing and exporting of commodities and finance.

Proton Desperately Seeking Savior

¶10. On May 22 Second Finance Minister Nor Mohamed Yakcop said the Malaysian government will not bail out Proton Holdings Bhd (Proton), creating even more pressure for the ailing carmaker to find a strategic partner. Proton, which has been engaged in talks with a number of potential foreign players including General Motors, Volkswagen and, PSA Peugeot Citroen, saw its cash reserves dwindle from RM 3 billion ringgit (\$882 million) at year-end 2004 to an estimated RM 500 million at present with some analysts predicting that the company will be cashless by 2008 if not sooner. On May 31 Proton announced a loss for the quarter ending March 31, the fourth straight quarterly loss. Also on May 31, Prime Minister Abdullah Badawi announced the effective end of talks between Volkswagen and Proton, reportedly due to Volkswagen's lack of interest in the equity terms Proton was willing to offer.

¶11. The brainchild of former Prime Minister Mahathir Mohamad, Proton has seen its market share slide to 32% from 60% at the start of the decade and shrinking almost 10% in 2006 alone. This is having a devastating effect on Malaysia's major Proton dealerships, 93% of whom did not break even in the first quarter of 2007, according to Proton Edar Dealers Association Malaysia president Wan Ahmad Sepwan. According to industry insiders here, Proton, which is 43%-owned by the GOM via Khazanah Nasional Bhd, is hamstrung when it comes to major decision making due to lack of direction at the top. Corporate management does not feel it has government support to make policy changes, while the government appears to be afraid of a political backlash if it pushes for cost reducing layoffs or appears to give too many concessions to potential foreign partners.

¶12. A manufacturing executive who supplies the industry said Proton purchasing agents cannot even get approval to make major parts buys in a timely fashion. Both executives cited quality control as a pervasive and intractable problem for Proton. The industry representative told us how he once saw two Proton quality control inspectors wearing full tool belts lean over the hood of a finished vehicle. One inspector subsequently tossed a clipboard across the hood of the vehicle to his partner, thereby scratching the paint. The executives reported that both of their firms have offered quality control training to Proton in the past, but the lessons never seem to make it from the classroom to the factory floor.

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